

Summary of Testimony of
Douglas W. Smith, General Counsel
Federal Energy Regulatory Commission
before the
Subcommittee on Energy and Power
Committee on Commerce
United States House of Representatives
June 8, 1999

The treatment of Kansas ad valorem tax payments under Natural Gas Policy Act (NGPA) price regulation has a long and complex litigation history. The NGPA, enacted in 1978, permitted producers to pass on to customers, the costs of taxes on production, but not the costs of property taxes. Purchasers asked the Commission in 1983 to find that the Kansas ad valorem tax was a property tax that could not be passed on. In reviewing a Commission finding that the Kansas tax could be passed on to customers, the United States Court of Appeals for the D.C. Circuit in 1988 criticized the Commission's interpretation and remanded the matter. In 1993, the Commission concluded on remand that the Kansas ad valorem tax was not recoverable from natural gas consumers, and required Kansas producers to make refunds back to June of 1988 -- the date of the court decision. In 1996, the D.C. Circuit sustained the Commission's conclusion that the tax payments were not recoverable, and held that the Commission also must order natural gas producers to refund amounts producers collected from 1983 through 1988.

In 1997, the Commission denied a request for generic waiver of interest on the refund obligations for the 1983 to 1988 period. At the same time, the Commission provided that it would consider requests for special hardship waivers on a case-by-case basis.

With respect to the 1983 to 1988 period, approximately \$339 million in refunds is owed by producers, of which \$129 million is principal, and \$210 million is interest. As of May 1999, producers have paid about \$95 million of these refunds, including principal and interest. Approximately 130 requests asking for partial or full waiver of refund obligations have been filed with the Commission.

H.R. 1117, a bill that would preclude the Commission from ordering interest on refunds of pre-1989 ad valorem tax payments, raises several issues. For example, instead of providing waiver relief on a case-by-case basis, it would provide across-the-board relief from the interest obligation without regard to hardship, to the detriment of consumers. Moreover, the bill is not clear as to its intended effect on refunds already made.

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Mr. Chairman and Members of the Subcommittee:

Good morning. My name is Douglas Smith, and I am the General Counsel at the Federal Energy Regulatory Commission. I am here today as a Commission staff witness, and do not speak for the Commission itself or for individual members of the Commission. Thank you for the opportunity to appear before you today to discuss the issues surrounding the treatment, for purposes of price regulation under the Natural Gas Policy Act, of payments of ad valorem taxes to the State of Kansas by natural gas producers.

The central issues -- Do Kansas producers owe refunds of amounts collected in excess of the statutory ceiling prices? For what time period are refunds due? Should refunds include interest on overcharges? -- have been extensively litigated before the Commission and the courts beginning in 1983. H.R. 1117, which would preclude the inclusion of interest in any refunds ordered, would have the effect of modifying the outcome of Commission orders implementing a 1996 decision of the United States Court of Appeals for the District of Columbia Circuit requiring producers to refund all Kansas ad valorem tax reimbursements they received from their customers from October 1983 through the removal of federal price ceilings on January 1, 1993.

I will describe the background and history of the dispute concerning Kansas ad valorem taxes,

discuss the current status of refunds and requests for waivers, and comment on issues raised by H.R. 1117.

Statutory Framework

Before 1978, the Commission regulated sales by natural gas producers under the Natural Gas Act (NGA), establishing just and reasonable rates to be charged by producers.

The Natural Gas Policy Act of 1978 (NGPA) replaced the Commission's NGA regulation of producer sales with a system of congressionally specified ceiling prices that producers could charge for their sales of natural gas. NGPA section 110 allowed producers to charge their customers amounts in excess of the applicable ceiling prices "to the extent necessary to recover... State severance taxes attributable to the production" of natural gas. Section 110 defined severance tax as "any severance, production, or similar tax, fee, or other levy imposed on the production of natural gas" by a state. The Wellhead Decontrol Act of 1989 ended NGPA regulation of all sales by natural gas producers effective January 1, 1993.

History of the Case

The State of Kansas has charged natural gas producers an ad valorem tax with respect to natural gas in Kansas since before the enactment of the NGPA. In 1974, the Commission's predecessor, the Federal Power Commission (FPC), held that Kansas producers could recover the cost of the Kansas ad valorem tax as an add-on to the national just and reasonable rates the FPC was then establishing for sales of natural gas by producers. Opinion No. 699-D, 52 FPC 915 (1974). The FPC held that the Kansas ad valorem tax could be considered as similar to a severance tax because it was based largely upon production factors.

Following the enactment of the NGPA, the Commission similarly treated the Kansas ad valorem tax as a severance tax that producers could recover as an add-on to the ceiling prices under NGPA section 110. However, in 1983, Northern Natural Gas Company, a pipeline company purchasing gas from Kansas producers, asked the Commission to reverse that ruling. It argued that the Kansas ad

valorem tax was a property tax on the value of the gas in the ground, rather than a severance tax on the production of gas, and thus producers should not be permitted to recover the Kansas ad valorem tax as an add-on to the ceiling prices. Northern Natural argued that the Commission had made a similar finding with respect to Texas' ad valorem tax. In 1986, the Commission upheld its earlier rulings that the Kansas ad valorem tax could be recovered as an add-on to the ceiling price, while the Texas ad valorem tax could not. Sun Exploration & Prod. Co., 36 FERC ¶ 61,093 (1986), reh'g denied sub nom. Northern Natural Gas Co. 38 FERC ¶ 61,062 (1987).

In June 1988, the U.S. Court of Appeals for the D.C. Circuit critically reviewed the Commission's analysis of the Kansas tax, and found that the Commission had not adequately explained its decision to treat the Kansas tax as a tax on production and had not adequately distinguished the Kansas and Texas ad valorem taxes. Colorado Interstate Gas Co. v. FERC, 850 F.2d 769 (D.C. Cir. 1988)(Colorado Interstate). The court therefore remanded the matter to the Commission for a more "cogent theory" of what distinguishes a production or severance tax which a producer can recover as an add-on under section 110 from a non-recoverable property tax. Id. at 773.

In a 1993 order on remand, the Commission set out the standards for determining whether NGPA section 110 permitted producers to recover a particular tax as an add-on to NGPA ceiling prices. Among other things, the Commission held that a recoverable severance tax is a tax on the value of the volumes of gas removed from the ground. A non-recoverable property tax, by contrast, is a tax on the value of the gas remaining in the ground, as well as on the value of wells and other production assets on the lease. Applying those standards, the Commission concluded that the Kansas ad valorem tax, like the Texas ad valorem tax, was a "tax on property, not on production," and, therefore, producers could not recover it as an add-on to the ceiling price under NGPA section 110. Colorado Interstate Gas Co., 65 FERC ¶ 61,292 at 62,371 (1993), order on reh'g, 67 FERC ¶ 61,209 (1994).

However, the Commission required Kansas producers to make refunds only back to the June 1988 date of the court's decision in Colorado Interstate. The Commission held that, until the court's decision, producers could reasonably have relied upon the Commission's previously settled rule that the Kansas ad valorem tax could be recovered as an add-on to the ceiling price.

Producers appealed the Commission's decision, arguing that the Commission should have reaffirmed its prior determination that the Kansas ad valorem tax could be recovered as an add-on to the ceiling price, and, in any event, should have ordered refunds only prospectively from the date of its decision in 1993. The Public Service Company of Colorado, supported by the Missouri Public Service Commission, also appealed the Commission's order, arguing that the Commission should have required refunds back to 1983, when the qualification of the Kansas ad valorem tax as an add-on to the ceiling prices was first challenged.

In 1996, the U.S. Court of Appeals for the D.C. Circuit affirmed the Commission's holding that the Kansas ad valorem tax was a property tax that could not be recovered as an add-on to NGPA ceiling prices. Public Service Company of Colorado v. FERC, 91 F.3d 1478 (D.C. Cir. 1996) (Public Service). However, the court rejected the Commission's finding that, before June 1988, producers had reasonably relied on the Commission's prior rule that the Kansas ad valorem tax could be recovered as an add-on to the ceiling price and thus that refunds should not be required before that date. The court explained its decision as follows:

[T]he status of the Kansas tax was expressly drawn into question in 1983 when Northern Natural first petitioned the Commission for a ruling that producers could not lawfully recover the tax under section 110. Once the recoverability of the tax was in dispute, we do not see how the Commission could possibly find that the producers reasonably relied upon continuing to recover it. . . . Absent detrimental and reasonable reliance, anything short of full retroactivity (i.e., to 1978) allows the producers to keep some unlawful overcharges without any justification at all. The court strongly resists the Commission's implication that the Congress intended to grant the agency the discretion to allow so capricious a thing. Still, we do not require refunds of taxes recovered with respect to production before October 1983 because there is before us no controversy over those monies.

Id. at 1490. Accordingly, the court concluded that the producers' liability for refunds should extend

back to October 1983, the date when parties were given notice that the recoverability of the tax was at issue. The court remanded the matter to the Commission to implement the refunds. The Supreme Court declined to review the Court of Appeals' Public Service decision. Public Service Company of Colorado v. FERC, 520 U.S. 1224 (1997).

In late 1994, while the appeal of the Commission's 1993 order requiring refunds for the period 1988-1993 was pending, the producers paid the refunds for the 1988-1993 period. The producers paid approximately \$125 million, which included interest.

In May 1997, after the Supreme Court declined to review the Public Service decision, a number of producers asked the Commission, in considering the Court of Appeals' remand, to grant all producers an across-the-board waiver of any requirement that they pay interest on their refunds of the reimbursement of ad valorem taxes collected during the period 1983 through 1988.

The threshold question for the Commission was whether a waiver of interest would violate the court's decision. The court held that "[p]roducers are liable to refund all Kansas ad valorem taxes collected with respect to production since October 1983." 91 F.3d at 1492. The Commission concluded that refunds without interest would not satisfy the court's requirement of full refunds. The Commission explained that both the Commission and the courts have consistently treated interest as a necessary element of full refunds because interest is necessary to reflect the time value of money. The Commission pointed out that its regulations require interest to be paid on refunds both to provide just compensation for the losses, or costs, imposed on those who have paid excessive rates and to reflect the benefits which were available to companies which collected excessive rates. Public Service Company of Colorado, 80 FERC ¶ 61,264 (1997), reh'g denied, 82 FERC ¶ 61,058 (1997).

The Commission found that the court's decision required rejection of the producers' equitable argument in favor of waiving interest. The producers argued that imposing interest charges on them was unfair because they had relied on the Commission's prior rulings that the Kansas ad valorem tax did qualify as an add-on to the ceiling prices. The Commission, however, stated that the court had already

found any such reliance by producers was both "foolhardy" and unreasonable. 91 F.3d at 1490. The Commission thus concluded that the Public Service decision left it with little choice but to deny an across-the-board waiver of the requirement to pay interest on the refunds required by the court.

The Commission was mindful, however, that the refund obligation with interest could present serious financial problems to specific producers. Accordingly, the Commission stated that it would consider individual producers' requests for relief from the refund requirement based on their particular circumstances. A petition for review of the Commission's decision is currently pending before the U.S. Court of Appeals for the D.C. Circuit, which has scheduled oral argument for September 7, 1999.

Status of Refunds

Based on the Commission's 1993 order, producers paid, in 1994 and 1995, \$125 million in refunds for the 1988-1993 period, which included interest. Because of the timing of the ad valorem tax bills, these refunds included the tax payments for all of 1988.

Since the Commission's September 1997 order implementing the court's decision, nine pipelines have reported to the Commission that producers owe refunds for the reimbursement of Kansas ad valorem taxes of approximately \$339 million for the 1983-1988 period. Of that amount, the Commission estimates that approximately \$129 million is principal. The remaining \$210 million is interest. Under the Commission's regulations, as set forth in 18 CFR § 154.501(d), interest is calculated from the date of collection from the customer based on the average prime rate for each calendar quarter as published by the Federal Reserve. As of May 1999, the producers have paid about \$95 million of refunds, which includes both principal and interest. Thus, producers still owe about \$244 million in refunds.

Approximately 130 requests have been filed with the Commission for waiver of all or part of a producer's refund obligation. The Commission has acted on eleven of those requests, granting six,

denying three, and dismissing two as unnecessary. In general, the Commission grants such requests where the applicant can show that payment of the refund will cause it a special hardship. Where a producer's application for relief contains insufficient information for the Commission to make a determination, the Commission's staff contacts the producer and indicates the type of information which it should file in order to support its application for a waiver.

The Commission's orders require that interstate pipelines receiving refunds must flow those refunds through to their customers, with the exception of three pipelines (Natural Gas Pipeline Company, ANR Pipeline Company, and El Paso Natural Gas Company) which have Commission-approved settlements with their customers that permit the pipelines to retain all refunds they receive in exchange for certain benefits they granted to their customers. The initial refund reports filed by the pipelines in May 1998 indicate that the amount those three pipelines may retain is \$4.9 million, or about 1.5% of the total \$339 million in ad valorem tax refunds. The remaining 98.5% of the refunds will be flowed through to at least 225 local distribution companies serving consumers in at least 13 states: Colorado, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, Ohio, Texas, Wisconsin, and Wyoming.

Proposed Legislation

H.R. 1117 would add the following new section to the NGPA:

Section 603. REFUNDS.

In the event any refunds of any rates and charges made, demanded, or received for reimbursement of State ad valorem taxes in connection with the sale of natural gas prior to 1989 are ordered to be made by the Commission, the refunds shall be ordered to be made without interest or penalty of any kind, and the refunds shall be required only to the extent that the purchaser demonstrates to the Federal Energy Regulatory Commission that the refund will be passed on to ultimate consumers of the natural gas.

Chairman Barton's letter of invitation asked for comments on this proposal to waive the inclusion of interest in refund amounts.

Neither the Commission as a whole nor Chairman Hoecker has taken a position on this

legislative proposal. However, I do have several observations to make concerning the proposed legislation.

First, the required refunds may cause some producers, particularly some small producers, financial hardship. As described above, the Commission's September 1997 order stated that the Commission may waive an individual producer's obligation to refund both principal and interest in cases of special hardship. The Commission considers such petitions for waiver on a case-by-case basis. An across-the-board waiver of interest, as proposed in H.R. 1117, would give all Kansas producers, without regard to hardship, partial (i.e., interest but not principal) relief without having to file with the Commission individual applications for relief from the refund requirement and supporting those requests.

If interest is not provided in refunds, consumers would not receive full reparation for the overcharges, because the refunds would not reflect the time value of money. This would be contrary to the Commission's regulations concerning refunds, which provide for appropriate interest to be paid in connection with all refunds. 18 CFR § 154.501 (1998). That requirement is consistent with a policy of requiring regulated entities that have overcharged consumers to provide full compensation for the overcharges.

Second, although H.R. 1117 would preclude penalties, penalties are not at issue in these cases. The Commission's orders described above provide that producers must pay interest on their refunds of Kansas ad valorem tax amounts, but the Commission has not imposed any penalties on the producers. The assessment of interest in refund calculations is not intended to penalize the producer, but rather to fully compensate the consumer for overcharges paid years earlier.

Third, H.R. 1117 would preclude refunds unless the purchaser demonstrates that refunds will be passed on to ultimate consumers. The Commission's orders require interstate pipelines to flow through all refunds to their customers, except for three pipelines that have settlements with their customers permitting the pipelines to retain the refunds. In those cases, in return for certain benefits the pipeline

had granted to their customers, the customers had agreed to allow the pipeline to retain all refunds the pipeline received from the producers. Natural, 85 FERC ¶ 61,001 (1998); El Paso, 85 FERC ¶ 61,003 (1998); ANR, 85 FERC ¶ 61,005 (1998). The flow through of refunds by local distribution companies is a matter subject to state regulation.

Finally, the intended effect of the legislation on refunds already made is not clear. First, there is ambiguity with respect to refunds made after the Commission's 1993 order. By its terms, H.R. 1117 applies to the period before 1989. As discussed above, the 1993 Commission order provided that producers refund Kansas ad valorem taxes collected after June 1988. The 1993 order covered essentially all ad valorem taxes producers collected with respect to their 1988 sales, because Kansas generally calculated its ad valorem tax bills due as of January first as late as November of the same year, and sometimes even later, and the producers then billed their customers for reimbursement for their 1988 ad valorem tax payments. The Commission required producers to refund all such amounts as overcharge occurring after the June 1988 cut-off date, and the producers refunded those amounts in 1994 and 1995. As now worded, the proposed legislation could be interpreted as invalidating the requirement in the 1993 order that the producers' 1988 refunds include interest, and producers might request the Commission to provide a means for them to recover that interest.

In addition, it is not clear whether the proposed legislation would apply to the interest component of the approximately \$95 million in refunds producers have already paid pursuant to the Commission's 1997 order. Thus, if the proposed legislation is enacted in its current form, producers might ask the Commission to provide a means for them to recover from pipelines interest already paid pursuant to the 1997 Commission order implementing the D.C. Circuit's Public Service decision. The pipelines could be expected to seek recovery of those amounts from their customers. In order to minimize further litigation of this protracted dispute, any legislation in this area should be clear as to its intended effect.

Conclusion

The Commission is in the unenviable position of trying to bring to closure this dispute which lingers from an earlier era of pervasive Federal regulation of natural gas prices. Even a decade ago, the court in Colorado Interstate noted the "special context" of this case -- a dispute about the application of the arcane law of price regulation at a time when natural gas markets were moving to competitively determined prices -- and observed that "FERC's task on remand may be about as inviting as having to make costly repairs on a building slated for demolition." 850 F.2d at 775. Nevertheless, the Commission will continue to apply the law and consider the equities on all sides -- producers, consumers, pipelines, and states -- in working this matter through to completion in a timely manner.

Thank you for the opportunity to testify this morning. I would be pleased to answer any questions you may have.